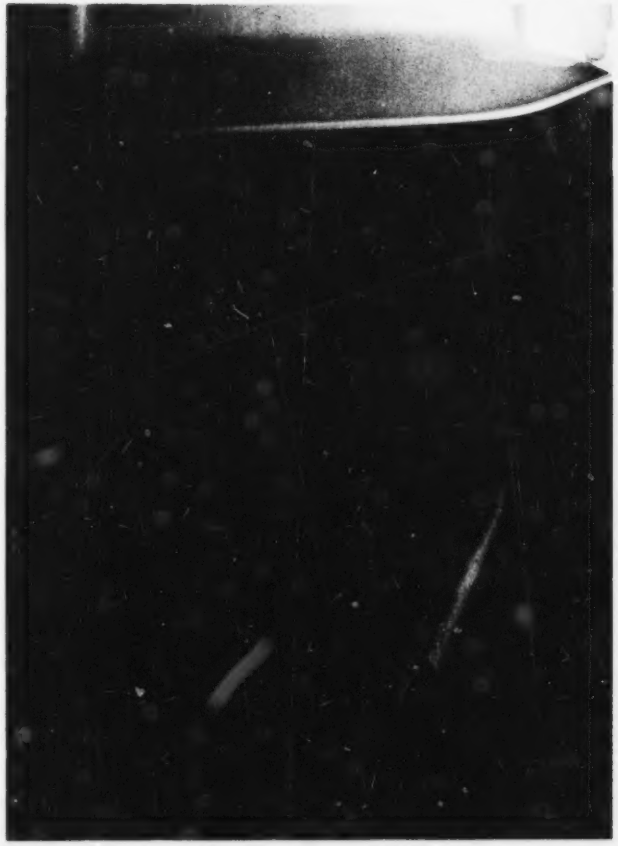
saskoil 1986



Annual Report

BEFORE WE TELL YOU WHAT WE'RE GOING TO DO, WE'D LIKE TO TELL YOU WHAT WE ARE.

saskoil is. . .

The number of calls I receive on a daily basis has increased a lot since we became a publicly traded company on January 14, 1986. Some callers still think we're a crown corporation. But with almost 10,000 registered shareholders across Canada, and with shares traded daily on the Toronto Stock Exchange and the Montreal Exchange, this isn't the case. Every Canadian citizen or resident of Canada is now eligible to participate in direct ownership of Saskoil.

Although much of our past success has been in heavy oil, over 60 percent of our 1986 production was comprised of light and medium oil. The United States imported 80 percent of our production, while the remainder was shipped to refiners in eastern Canada. In terms of natural gas, our production of 1.4 billion cubic feet marked a 100 percent increase over 1985, and established a new company record.

Participation bonds of $15 million, which are due in 1990, are our only debt. This amount is only five percent of debt and shareholders' equity — a very low figure when compared to other companies in the western Canadian oil industry.

Even though our building only officially became Saskoil Tower in January 1986, we've been a part of the Regina business community since our inception in 1973. Of our 220 employees, 142 are located at head office while 78 work from field offices in Coleville, Maidstone, Swift Current and Estevan.

With numerous oil wells spread over 775 thousand net acres of land, the work of our field staff is vital to maintaining our high level of production. They've worked hard. In 1986 we were the third largest oil producer in Saskatchewan and one of the top 25 in Canada.

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2 **TO OUR SHAREHOLDERS** This section provides you with an overview of the operational and financial position of our company in 1986. It features a discussion on the economic environment, a review of 1986 accomplishments, and our vision of 1990.

5 **QUESTIONS FROM SHAREHOLDERS** Over the year, we received calls and letters from shareholders with concerns and questions. We have selected the most often asked questions and provided you with the answers.

9 **PROJECT BRAZEAU** We have found that far too many annual reports give you facts and statistics and neglect to tell you how the company does its business. Here we try and do just that. Twelve employees give a personal account of their roles on the Brazeau project.

16 **OPERATIONS** In order to simplify the statistical data, our operational information has been presented in a series of tables. If you are looking for Saskoil's statistical story, you will find it here.

22 **FINANCIAL REVIEW** Although we touch on our financial position in the "To Our Shareholders" section, the Financial Review will give you an in-depth look at the important financial components of our company.

24 **FINANCIAL STATEMENTS** This section includes the Management and Auditors' reports, the Balance Sheet and Statements of Earnings, Retained Earnings, and Changes in Financial Position, and the notes to the Financial Statements.

32 **FIVE YEAR SUMMARY** These two pages provide you with a detailed summary of our financial and operational performance over the last five years.

34 **SHAREHOLDERS' INFORMATION** We have structured this section to provide you with a comprehensive review of Saskoil's share capital. Contents include share trading ranges and geographic breakdown of outstanding shares.

36 **CORPORATE INFORMATION** Here you will meet our Board of Directors and Officers of the company. If you would like to write or visit us, we've included the addresses of our head office and district offices.

To Our Shareholders

Compared to previous record-setting years for Saskoil, 1986 stands in stark contrast. Our performance was hindered by world oil prices which fell from $30 U.S. per barrel in December of 1985 to $10 by the end of March 1986, and fluctuated between $12 - $16 through to year-end. As a result, Saskoil earnings, which were $40.6 million in 1985, decreased to a $1.3 million loss in 1986 for a loss of $0.34 per common share. It is of little consolation to us that other oil companies are reporting similar results.

While the unsettled nature of the industry was the most notable feature of 1986, we are able to report some significant company happenings. Oil production remained strong over the twelve-month period as 4.8 million barrels were produced. This is a tribute to our head office and field staff who worked hard to maximize production despite having to shut-in 10 percent of our wells that proved uneconomic to operate. Natural gas volumes of 1.4 billion cubic feet were the highest in the history of the corporation, and were supported by prices which remained relatively stable during the decrease in the price of oil.

The financial integrity of Saskoil has remained intact, during this overall period of volatility. The company was successful in operating within cashflow and, therefore, accumulated no new debt.

Saskoil's initial share offering in January 1986 was primarily responsible for increasing cash on hand to $42.5 million by year-end. Saskoil's financial resources have provided stability during a time when many competing oil companies have staggered under excessive debt loads.

1986 Economic Conditions

OPEC (Organization of Petroleum Exporting Countries) has captured headlines for over a year with internal feuding that can be traced back to rapid oil price increases of the 1970's. These increases resulted in too much supply and too little demand, and created a situation in which OPEC market share was dwindling. Saudi Arabia has been at the centre of attention because its refusal to continue acting as *swing producer* — raising or lowering its daily oil production in order to keep prices high — precipitated the world oil price free-fall. Its immense oil supplies have allowed it to exert considerable control over the market and force other oil producing nations to either accept smaller market shares or suffer financial losses. Continued internal fighting among OPEC members and the degree to which non-OPEC countries will co-operate in production cut-backs makes it very difficult to predict when higher oil prices will come. But the consensus is that OPEC is coming out of this stronger and wiser — not likely to force prices up too quickly, yet disciplined enough to keep oil prices above production costs.

we have met the challenge of low prices

OPEC's actions prompted the Canadian federal government, along with several provincial governments, to lessen the pressure placed upon the western Canadian oil industry. In October, the federal government announced the removal of PGRT (Petroleum and Gas Revenue Tax). This was welcomed because it completed the demise of the National Energy Program. Saskoil paid PGRT of $13.5 million in 1985.

On a provincial level, the Alberta government implemented a comprehensive incentive plan in October that included a royalty holiday designed to stimulate new drilling. This change has increased the attractiveness of new investment in Alberta and supports our aggressive strategy of investing in that province to balance our operations.

The Saskatchewan government put in place a temporary royalty relief program from May through October, and in December, a more permanent royalty regime was unveiled. Under the regime, royalties will be cut by six percent to 13 percent on certain types of production, and virtually eliminated on low-productivity wells. The one-year royalty-free period on new oil wells was extended to three years for wells drilled before mid-1988. And, like Alberta's, the new Saskatchewan royalty rate is price sensitive, rising and falling with world oil prices. This is a feature that had been missing from previous provincial royalty programs and one that is welcomed by Saskoil and the Saskatchewan oil industry.

we are committed to growth and diversification

1986 Accomplishments

Although the fall of world oil prices came with little warning, we successfully adjusted to meet the challenge of reduced prices.

In terms of our operations, we shut-in those wells which proved uneconomic and conducted a careful analysis of *each* well that we operate to determine contribution to cashflow. After trimming costs where possible, we began disposing of wells that did not generate a sufficient profit margin. This, in turn, enabled us to focus our attention on the remaining wells, optimizing their production and cashflow. Results have proven encouraging to date as we have been able to maintain past levels of production with fewer wells, and have stopped increases to production costs.

Innovative approaches were used to increase the effectiveness of our marketing during the year. We negotiated long-term oil contracts with several buyers that will provide us with a stable outlet for sales over the next few years. We arranged shared batches of crude oil with other producers in order to make sales at times when crude was difficult to move. Our efforts have proven successful in this area and have led industry peers to consider us experts in heavy oil marketing. As a result, we currently act as an oil broker, selling over 5,000 barrels of oil per day for other companies at a commission fee. The network of marketing contacts developed in 1986 has improved our ability to make sales and respond more rapidly to changing market conditions.

We changed the focus of our exploration and development activity in 1986, expanding from Saskatchewan, to include the more prolific, economic plays of Alberta. This strategy will bring more geographic balance to our operations over time. Through farmins, internally developed prospects, and a lot of hard work, we have been very successful in re-directing our efforts.

The most difficult adjustment in 1986 involved reducing staff to a level more consistent with our expected revenue. In June, 26 percent of our employees were let go and the excess office space was sublet. These measures will save the company over $3 million during the next fiscal year.

As a result of adjusting our operations, we look forward to returning to profitability in 1987.

Our Vision of 1990

Prosperity over the longer-term depends on successfully using our financial resources to take advantage of higher oil and gas prices in the future. For this reason, Saskoil is committed to achieving growth and diversification. We will increase revenue by boosting our proved producing reserves 50 percent by 1990. This growth will also permit us to generate 50 percent of our revenue from natural gas and lighter Alberta oil by 1990, while maintaining our strong Saskatchewan base.

Growth in asset value depends both on reserve additions in excess of production volumes, and reserves value in excess of costs. The time to increase reserves is not when land and drilling costs are high as they have been the last several years, but now, when exploration costs are lower and opportunities exist to purchase reserves.

your confidence will be rewarded

Investment in natural gas and lighter oil will provide revenue stability through several important kinds of diversification. As a result, Saskoil's resource base will become more balanced over time and cashflow less susceptible to disruption.

A significant increase in natural gas reserves will make us an active player in the market when current excess supplies are absorbed. The benefit from natural gas investment made in 1987 and subsequent years, will be longer-term, and will provide a more balanced production mix.

More oil production in Alberta provides geographic diversification and lessens the risk that a change in policy by either provincial government will severely affect Saskoil. Light oil tends to command a higher sales price and is marketed in Canada to a greater extent. The higher productivity exhibited by light oil production will also lower production costs and increase the profit margin on each barrel of oil.

Our corporate goals for 1987 support our longer term strategic direction. Over the year we will generate reserve additions in excess of production volumes through acquisition, exploration, and development. We are committed to adding those reserves at costs below industry averages. Three-quarters of our reserve additions will be from natural gas and lighter oil. Finally, we will keep combined operating and administration costs lower than in 1986.

What This Means To You

By increasing oil and gas reserves — our primary asset — we will increase the net worth and long term profitability of the corporation. Diversification will allow us to better withstand fluctuations in prices, such as we have witnessed in the past year.

What this means to you, as a shareholder, is that the underlying value of your investment will increase and your confidence will be rewarded — an objective that the Board of Directors, management, and employees of Saskoil are committed to achieving. Your company has successfully emerged from this period of difficulty, and is well positioned to take advantage of current opportunities.

Questions From Our Shareholders.
Answers From Management.

As the price of crude oil dropped in 1986, the price of Saskoil common shares also dropped.

What is the relationship between oil prices and share prices?

The price of shares represents the investing public's estimate of a company's market value. Since Saskoil is almost exclusively an oil production company, the value of its future cash flow from production is closely linked to forecasted oil prices. When oil prices were high and expected to rise even further, the estimated value of future oil production was also high. With an eye to making capital gains, many investors were attracted to oil stocks, which, in turn, prompted share prices to rise. When investor confidence in our industry dropped with oil prices, there were more sellers than buyers, and the result was lower share prices.

The value of future production and shorter term financial results, both dependent on oil prices, have an impact on share prices. But many other factors — confidence in management, debt load, historical financial results, dividend performance, interest rates, and the general level of stock market activity — can have as much or greater effect.

When you consider these factors, Saskoil fares very well. Earnings in 1983, 1984, and 1985 were $30.9 million, $44 million, and $40.6 million respectively. Our company is virtually debt free with only $15 million in long term debt. And we have a solid reserves and production base. When world oil prices stabilize and investor confidence in our industry is renewed, share prices should increase.

I find some oil industry jargon confusing.

What does the "world" price of oil mean?

The world price of oil — the price level that balances supply and demand for crude oil in the international market place — is more concept than reality. In actual fact there is no single world price of oil. Each major source and type of crude is priced differently — Saudi light, North Sea Brent, and Mexican Mayan, for example. However, the prices of these crudes do tend to move in the same direction in response to factors that influence oil demand and supply.

West Texas Intermediate (WTI) crude, is the most relevant measure of the world price level for Saskoil. This is because much of Saskoil's production is sold into the mid-western U.S. refining area where WTI is readily available, and because WTI has become recognized by industry as the North American benchmark crude. Some of our contracts are tied to WTI prices directly.

Our oil prices differ from world prices due to transportation costs to the U.S. market, quality differences between our crudes and WTI, exchange rate fluctuations, and seasonal variations in demand. As a result of these factors, Saskoil's average oil price in Canadian dollars is about the same as the world oil price in U.S. dollars.

Without a substantial increase in prices,

What will it take to get the industry back on track?

Two things: the industry has to become more efficient in finding and developing oil, and governments must continue to recognize that they are partners with us in oil and gas investment.

Oil industry finding and development costs rose dramatically, along with the price of oil, in the early eighties. Our new economic environment dictates that the trend toward higher-cost reserve additions must be reversed. This will be the industry's greatest challenge — and only those companies that are successful, will survive and be profitable.

Of almost equal importance is the continued co-operation between government and industry in the area of taxes and royalties. Too often our industry is still seen only as a source of revenue, not as a major employer and essential industry. For example, a typical well in our Senlac field pays more than $1,100 per month in royalties, municipal taxes, mineral taxes and land rentals. This represents about 40 percent of our total operating costs.

True, only a rise in oil prices will bring certain projects back to life. But for companies like Saskoil that are financially strong now, a return to profitability is expected this year.

In one of your interim reports, I read that Saskoil is looking for opportunities in Alberta.

Why does Saskoil not concentrate on developing Saskatchewan's resources?

When you consider that 95 percent of our current production comes from Saskatchewan, it's certainly fair to say that we're not "giving up" on the province. However, since the dramatic drop in world oil prices, we have had to rethink our strategies and concentrate on those investments which do the most to promote corporate health. The economics of exploring in Alberta are more attractive than in Saskatchewan. Lower royalties, higher reserves potential and productivity per well, and higher quality oil are all factors in our decision to increase our emphasis in Alberta.

While we intend to remain active in Saskatchewan, it currently makes the most economic sense to shift some new investment to Alberta, thereby increasing profitability and diversifying revenue. After all, that is our responsibility to our shareholders.

Your full name is Saskatchewan Oil and Gas Corporation, but 95% of your revenue comes from oil production.

Where's the "gas"?

You're right. Natural gas production accounts for only a small portion of our current revenue.

For the past several years this has been a real advantage for Saskoil, because the western Canadian natural gas industry has been plagued with marketing problems. Only a handful of gas producers have been profitable during this period.

But the industry is constantly changing so we must stay one step ahead. We think natural gas opportunities exist now in both Saskatchewan and Alberta. This is proven by the fact that we doubled natural gas production in 1986 to 1.4 billion cubic feet, generating $3 million in sales. The Saskatchewan government has provided incentive by stating that it wants the province to become self-sufficient in natural gas by 1990.

The real pay-off from natural gas investments that we make now, will come in the longer term. As the current surplus of natural gas disappears, the export market will strengthen and grow. Saskoil will be positioned to take advantage of that market growth by substantially increasing natural gas reserves over the next several years.

Saskoil has a substantial cash reserve which I'm sure other oil companies envy.

Will Saskoil make a major acquisition?

First of all, we *are* in an enviable position. Very few oil companies have the financial strength of Saskoil — available cash and capacity for debt.

Will we make an acquisition? Yes, if the right deal can be found. It must be a good strategic fit and at the right price. The acquisition may consist of several smaller purchases of producing properties or one major purchase. We are actively pursuing acquisitions, and will continue to do so on an ongoing basis, as another way of adding reserves.

Although we have over $40 million in cash, the most desirable way to finance an acquisition would be through a share issue. We can then use our cash to further our exploration and development efforts.

There are times in the business cycle, such as now, when there are opportunities to accelerate growth through acquisitions of other companies less fortunate than us. The results can be beneficial for both Saskoil and the company acquired.

I've read that a heavy oil upgrading facility is being built in Regina.

How will the Co-op Upgrader benefit Saskoil?

We don't know for certain at this time, because contracts for crude oil and natural gas supplies to the Upgrader are not yet in place.

However, we do know that the Upgrader will expand and stabilize the Saskatchewan market for medium and heavy crude oil. Saskoil is a major producer in west-central and north-west Saskatchewan — locations from where the crude feedstock will likely come.

The Upgrader also requires substantial volumes of natural gas for its operation. Deregulation of the natural gas industry means that sales can be arranged directly between producers and industrial users of gas.

We view the Upgrader as a significant event in Saskatchewan's energy future. You can be assured that Saskoil will be aggressively and competitively pursuing the opportunities that it generates.

My wife and I got our preferred share dividends but,

Why didn't we receive dividends on common shares in 1986?

Common stock represents an equity ownership position in a company. The decision to pay dividends is made by the Board of Directors, and depends primarily on financial performance for the year and the company's investment opportunities.

In other words, if the company believes it has good investment opportunities, the money should stay in the company. Shareholders will see the results in terms of asset value growth and share price appreciation.

Although there can be no assurances as to future profits and, therefore, dividends, we have made several streamlining moves in our entire operation to make us profitable at current prices. It is our plan at this stage of our development to re-invest all earnings in order to achieve growth and diversification in corporate assets, rather than distribute earnings as dividends. We believe this will ultimately benefit the shareholders.

I know that profits are down for Saskoil.

Will we continue to get our preferred dividend payments?

Although we again cannot give you an absolute answer to this question because dividends must be declared for each quarter by the Board of Directors, we can give you some facts about our preferred shares.

First, we paid preferred shareholders dividends for all four quarters of 1986 even though we ended the year in a loss position. Second, preferred shares are "cumulative". In other words, if we miss a dividend payment in any given quarter, that amount is added to the next quarter's dividend, and so on, until there are sufficient corporate funds to pay preferred share dividends. Finally, preferred shareholders rank ahead of common shareholders in terms of priority in receiving dividend payments.

The Board of Directors has indicated its intention to continue preferred dividend payments unless it is impossible to do so.

EACH YEAR WE ATTEMPT TO GIVE THE READERS OF OUR ANNUAL REPORT AN UNDERSTANDING OF OUR BUSINESS. NOT JUST THE NUMBER OF WELLS DRILLED, ACRES OF LAND ACQUIRED OR VOLUME OF OIL AND GAS PRODUCED, BUT A FEELING FOR OUR SPIRIT IN TERMS OF PEOPLE, DIRECTION AND PURPOSE. WE BELIEVE THIS IS IMPORTANT, BECAUSE SASKOIL IS MORE THAN NUMBERS IN A BOOK. THE FOLLOWING SIX PAGES INTRODUCE YOU TO TWELVE EMPLOYEES FROM ALMOST ALL AREAS OF OUR COMPANY. THE VENTURE DISCUSSED IS "BRAZEAU", AN ALBERTA DEEP-WELL PROJECT WHICH THEY WORKED ON IN 1986.

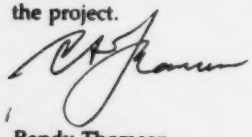
Randy Thomson; Llew Williams; Dick Walz; Stan Weidinger.

The image many people have of oil exploration is one created by Hollywood: crude bubbling out of swamps and black geysers spewing out of oil derricks. Not quite.

Oil exploration is a very complex business that begins with the acquisition of land. Land or mineral rights are leased through government land sales, from private landholders, or by striking an agreement with a competing oil company to work together on land they already have. The latter method, called a farmin, was how we got involved with Brazeau.

Our land team was searching for drilling opportunities when we got a lead on an oil company who needed a partner to help finance the exploratory drilling of Brazeau. But with costs for drilling pegged at $1.7 million, we wanted to be as sure as we can be in the oil industry that this well could deliver. Time for review.

Based on our initial calculations, we estimated that a successful well at Brazeau could produce 3300 barrels per day of oil and gas equivalent, which would result in a 16 percent addition to our overall production capacity. These estimates were staggering considering that the average well in Saskatchewan produces only 20 barrels of oil per day. They were also an indication that Brazeau was an opportunity we couldn't pass up. After finding two more partners to share exploration costs, we proceeded to further analyze the project.



Randy Thomsen
Manager,
Land Contracts

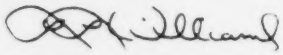
Our target at Brazeau was a Nisku pinnacle reef of Devonian age surrounded by impermeable basinal sediments under intense hydrodynamic pressure. Easy for me to say, right? Fortunately, this can be explained more clearly once we have an understanding of where oil is found.

First of all, out with the old. Oil is not found in pools or underground lakes; it's trapped in rock, like sandstone, thousands of feet down. Found with salt water and natural gas, oil stays there because it is surrounded by other rock that won't allow it and the other elements to rise to the surface. This oil zone is located in a rock layer called a formation.

Pinnacle reefs developed from coral reefs that once teemed with life, and took thousands of years to become formations that can trap oil. As the reefs died and new ones grew on top, they became large, porous masses — many of which filled with oil.

If you still have trouble visualizing an oil-bearing pinnacle, think of a 10-story office tower trapped under 11,000 feet of rock. The top two floors would be filled with natural gas, the next four filled with oil, and the bottom four filled with water. Pressure from the surrounding rock formations would be intense, causing the fluids and gas to rush to the surface if a hole were punched in the roof.

In our judgment Brazeau was situated in an area where reefs were known to exist, but required seismic to pinpoint the exact location.

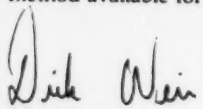


Llew Williams
Geologist

In the past, a water witch used a divining rod to find sources of water and oil. The modern-day science of geophysics is much more sophisticated. We use a source on the earth's surface, often dynamite, to bounce sound waves off rock formations and monitor their return with geophones — geophysicist's earphones. Electronic equipment in a seismic truck records this activity and creates a printout of squiggly lines which we interpret to determine which area of the rock layers has the potential to contain oil.

Now to pinnacle reef formations. Llew's analogy of the formation as an office building is good, but let me take it a bit further. Take Llew's 10-story building, place it in downtown Manhattan, and then cover the city with two miles of rock. Now find the building.

In the case of Brazeau, a very detailed seismic program was done by our partners prior to Saskoil's involvement. Saskoil, together with consultants, reviewed this data and confirmed the location of a potential reef. After the well was drilled, our geophysical efforts focused on performing a vertical seismic profile. This allowed us to lower very sophisticated seismic equipment down the drilled hole and perform a more complex analysis. Outside of lowering a geophysicist down the drilled hole, this was the best method available for exploring Brazeau.



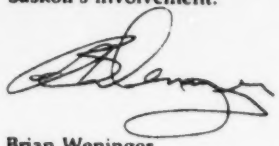
Dick Weir
Geophysicist

The technology and risks involved in oil exploration add a great deal of romance to the oil industry. But these projects have to indicate that they will make money before they are even undertaken. Economic analysis is where I come in.

Before we proceed with a full-scale exploration effort, we must draw up cash flow projections — costs versus revenue. The key to this projection is that we don't want the columns to balance; we want to see revenue far exceed costs. If a potential project doesn't meet our high return demands, then it is set aside.

With Brazeau, projected revenue far exceeded cost due to the valuable range of products that were believed to be in the formation. We even hired an external economic consultant to double-check our forecast on Brazeau because of the high exploration costs needed to drill the well. His analysis confirmed our appraisal.

Based on our understanding of the geology, economic projections, and high potential — all of which indicated an exceptional investment opportunity — senior management approved Saskoil's involvement.

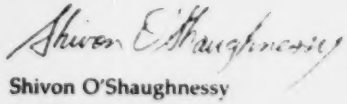


Brian Weninger
Analyst,
Project Evaluation

Shivon O'Shaughnessy; Reid French; Maureen Kelly; James Gelowitz.

Monitoring various expenditures is a critical part of the exploration process. That's where the Comptroller's Division enters. Our job is to ensure that the flood of expenditures is kept in perfect order.

This process begins with the development of an AFE (authorization for expenditure), which contains a cost estimate and management's commitment of funds to a project. The AFE is assigned an individual number that is recorded in our system and is used to accumulate costs tied to a project. These costs are then charged to the AFE number as invoices come in, and reported to management for information and cost control purposes. With the number of AFE's, projects, and various partnership agreements we have, keeping track of expenditures would be impossible with pen and paper. Thank heaven for our sophisticated network of computers. It not only assists in the accounting process, but also monitors the production performance of our wells — a factor that is of increasing importance to Saskoil.



Shivon O'Shaughnessy
Supervisor,
General Accounting

Some environmental problems are easily solved. A few years ago an oil tank ruptured, spilling heavy oil. The temperature was so cold and the oil so thick that cleanup procedures were simple: the frozen oil was cut with a chain saw, stacked in half-ton trucks and hauled away.

But Brazeau posed a much more complicated environmental challenge. Nestled in a heavily treed area of mid-Alberta, the drill site had to be cleared and the trees sent to a lumber mill for use. The proximity of the Pembina River meant that a spill in this area could have serious consequences. Special precautions had to be taken. In addition, an emergency response contingency plan had to be developed in the event that the well erupted from a blowout, capable of launching the drill pipe into orbit and spewing out deadly hydrogen sulphide gas. Fortunately neither plan had to be used.

At Saskoil we view the environment as a valuable resource, and work hard to preserve local surroundings while carrying on the task of oil exploration. It is a responsibility that we take seriously.

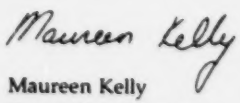
Reid French
Co-ordinator,
Environmental Affairs

My work on Brazeau involved securing insurance and arranging capital advances. Both were unusual, giving me the impression that Brazeau was different from most exploration wells.

A special policy had to be purchased for this location due to its blowout potential. The premium was very expensive: about one third of that paid for the entire year of well control insurance on all of Saskoil's wells. Considering the potential consequences though, it was worth it.

The next step was arranging capital advances. One of our partners was invoiced by telecopier for $300,000 just as drilling was about to begin.

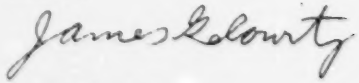
The money from this partner was wired into Saskoil's account in less than twenty-four hours, proving that money travels fast in the oil business.



Maureen Kelly
Financial Accountant

Drilling for oil isn't easy. Less easy in the case of Brazeau. Here was a formation two miles down and believed to be pressurized with hydrogen sulphide gas. Drilling the hole straight over that distance and getting through the hard rock without the hole caving in were major concerns. But neither were as serious as a potential blowout. Planning was more involved than for a typical, shallow Saskatchewan well. A special drill rig, drill pipe design, and drill bit had to be selected. A special semi-solid solution of mud had to be used, since it would be the mud's job to counterweight the gas and keep it from bursting out of the hole. And finally, a special crew had to be selected to perform the drilling. These guys had to live on-site and work around the clock in eight-hour shifts for 50 consecutive days. That's why they're special.

At Brazeau, there was a lot more pressure than just that at the bottom of the hole.



James Gelowitz
Manager,
Drilling

Brian
McConnell;
ary Follensbee;
James Repski;
Kim Hilkewich.

Successful drilling of a well does not always mean a large amount of oil will be recovered. In formation evaluation, our job is to test the oil-saturated rock layers, determine how much oil is down there, and if it can be successfully recovered. In other words, we check to see if the well can do what we thought it could originally do.

Like the other professionals involved in the exploration cycle, we too use a great deal of space-age equipment to make our determinations. The most basic instrument we use is called a well log tool. This is a torpedo-shaped device that is lowered to the bottom of the drilled hole and then drawn back to the surface. As the tool rises, it shoots gamma rays into the rock layers, producing a seismic-like printout. By analyzing this printout, we can determine the amount of pore space the oil bearing rock has in addition to the inter-connection of the pores. The more pores and the better connected they are to one another, the easier oil will flow and the more oil we will recover.

It might seem like the job of finding oil has become simpler, but it hasn't. All the easy oil has been found, making new reserves harder and harder to find. Especially given the intense competition in our industry. That's why high risk ventures like Brazeau are a necessity.

Brian McConnell
Manager,
Evaluation Services

The job of a reservoir engineer is a rather complex one involving technical and economic studies to determine how to get the most oil or gas out of the ground. How a well is produced today can seriously affect its future productivity and its ultimate profitability. This project offered an interesting challenge.

A typical pinnacle reef reservoir is filled with natural gas saturated liquids. With pressure changes the gas will condense into a liquid in the reservoir. The trick is to maintain sufficient pressure in the reservoir so that the gas does not condense. Easier said than done. How do you keep the pressure up but also produce the gas — which, in turn, lowers the pressure? Believe it or not gas has to be reinjected into the reservoir to produce more liquid. In some cases we even have to buy gas for reinjection if there is insufficient produced gas. Keeping the proper balance is a very delicate procedure. The method requires the use of detailed reservoir simulation models consisting of equations and formulas that describe the dynamics two miles down in the ground. From these models, we can determine the various options for producing the gas and select the one that best optimizes its recovery.

Gary Follensbee
General Manager,
Resource Recovery

The well is nothing more than a hole in the ground when I enter the picture. Determining the best method to complete it will ensure that oil and gas production and profit are maximized. This task begins with cementing pipe in the drill hole and carries through to the design and construction of facilities. When the producing formation is under very high pressure, the fluids will flow naturally to the surface. This simplifies one phase of the design since lifting equipment — including the pumpjack — is not required. But couple this pressure with the highly corrosive components contained in the gas, and other problems evolve. The materials used must be able to survive in this harsh environment as improper selection of production hardware would result in rapid deterioration and eventual equipment failure.

Rigorous attention to detail can prolong the production life of the well, provide safe operation, and maximize financial returns.

James Repski
Supervisor,
Production Engineering

My job involves the day-to-day maintenance and operation of numerous oil and gas wells and treating facilities. I have to make sure oil and gas keeps moving under almost any conditions.

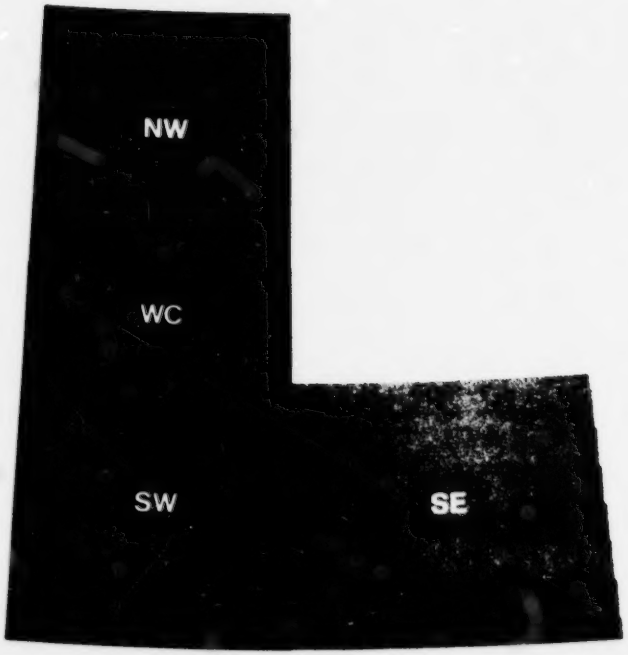
I won't know until mid-1987 if I'll be operating Brazeau. Initial results indicate that we failed to find a pinnacle reef. However, we're still waiting for our head-office people to analyze some of the upper zones that we drilled through. We're confident that the well will be operated and that we can recover some of our drilling costs through production.

When you look at our hunt to find Brazeau, it does have the guts of a Hollywood movie: money, drama, risk. But that's the nature of our business. Everyone in it knows that you can spend a forturne exploring for a well and produce nothing when you miss it by as little as 50 feet. It's that reality that characterizes the oil industry. And which makes the rewards of success so sweet.

Kim Hilkewich
Assistant Foreman

Operations

Saskoil's Saskatchewan operations are divided into four main districts: South East, South West, West Central, and North West. Over 4.6 million barrels of our annual production comes from these districts.



Imperial Conversion

To Convert From:	To:	Divide By:
barrels (bbls)	cubic metres (m^3)	6.293
billion cubic feet (bcf)	million cubic metres (10^6 m^3)	0.035494
feet (ft)	metres (m)	3.281
miles (mi)	kilometres (km)	0.621
acres (ac)	hectares (ha)	2.471

Oil and Gas Reserves

(as at December 31, 1986)

	Proved		Probable		Total Proved Plus Probable	
	Gross	Net*	Gross	Net*	Gross	Net*
Crude Oil (thousands of barrels)						
Saskatchewan	42,333	31,749	24,624	18,465	66,957	50,214
Alberta	1,132	1,050	321	296	1,453	1,346
Manitoba	206	164	49	38	255	202
Total	**43,671**	**32,963**	**24,994**	**18,799**	**68,665**	**51,762**
Gas (millions of cubic feet)						
Saskatchewan	30,034	27,015	14,413	12,957	44,447	39,972
Alberta	14,023	13,029	10,260	9,550	24,283	22,579
Total	**44,057**	**40,044**	**24,673**	**22,507**	**68,730**	**62,551**

*Net of royalties

Total Reserves

(as at December 31, 1986)

	Oil (thousands of barrels)				Gas (millions of cubic feet)	
	Gross Before Royalties			Net of Royalties	Gross Before Royalties	Net of Royalties
	Light & Medium	Heavy*	Total	Total	Total	Total
Proved Producing						
At December 31, 1985	34,341	8,836	43,177		2,024	
Adjustments	830	1,698	2,528		12,283	
Additions	1,006	25	1,031		533	
	36,177	10,559	46,736		14,840	
Less: Production	3,029	1,727	4,756		1,420	
Total Proved Producing	33,148	8,832	41,980		13,420	
Proved Non-Producing	1,314	377	1,691		30,637	
Total Proved	34,462	9,209	43,671	32,963	44,057	40,044
Probable	14,258	10,736	24,994	18,799	24,673	22,507
Total Proved Plus Probable	48,720	19,945	68,665	51,762	68,730	62,551

*Heavy oil generally means a high viscosity oil that is less than 20 degrees API gravity. API gravity is the American Petroleum Institute standard for the specific gravity of oil.

Exploration Expenditures

(thousands of dollars)

	1986	1985	1984	1983	1982
By Objective					
Light/Medium Oil	$ 8,015	$13,287	$11,559	$ 4,896	$ 7,280
Heavy Oil	817	6,643	3,182	4,899	6,669
Gas	1,695	2,214	2,010	49	270
Total	**$10,527**	$22,144	$16,751	$ 9,844	$14,219
By Activity					
Land	$ 1,844	$ 9,658	$ 7,940	$ 3,591	$ 3,627
Drilling	5,361	7,449	4,576	2,512	5,728
Geophysics	2,915	4,315	2,650	2,055	2,058
Lease Rentals	407	722	1,585	1,686	2,806
Total	**$10,527**	$22,144	$16,751	$ 9,844	$14,219

Development Expenditures

(thousands of dollars)

By Activity					
Development Drilling	$ 4,187	$17,796	$18,330	$14,870	$15,698
Facilities	4,683	5,921	7,340	1,760	1,804
Waterflood	2,610	10,455	—	—	—
Other	1,630	2,282	1,696	3,040	—
Total	**$13,110**	$36,454	$27,366	$19,670	$17,502

Drilling Activity

	1986		1985		1984		1983		1982	
	Gross	Net	Gross	Net	Gross	Net	Gross	Net	Gross	Net
Capital Interest										
Exploratory Wells — Oil	11	3.5	28	16.6	26	14.2	9	5.4	28	15.3
— Gas	1	0.3	1	0.3	4	4.0	—	—	5	1.1
— Dry	7	4.3	22	11.6	22	11.0	11	5.1	10	5.8
Total Exploratory	19	8.1	51	28.5	52	29.2	20	10.5	43	22.2
Development Wells — Oil	120	15.8	424	103.2	302	85.1	128	70.2	95	47.4
— Gas	—	—	—	—	—	—	—	—	2	0.7
— Dry	3	0.8	13	7.8	12	7.9	10	5.4	7	3.2
Total Development	123	16.6	437	111.0	314	93.0	138	75.6	104	51.3
Total Capital Interest — Oil	131	19.3	452	119.8	328	99.3	137	75.6	123	62.7
— Gas	1	0.3	1	0.3	4	4.0	—	—	7	1.8
— Dry	10	5.1	35	19.4	34	18.9	21	10.5	17	9.0
	142	24.7	488	139.5	366	122.2	158	86.1	147	73.5
Farmout Wells	27	—	164	—	63	—	95	—	13	—
Total Wells	**169**	**24.7**	652	139.5	429	122.2	253	86.1	160	73.5
Success Ratio — Capital Interest Wells										
Exploratory	63.2%	46.9%	56.9%	59.3%	57.7%	62.3%	45.0%	51.4%	76.7%	73.9%
Development	97.6%	95.2%	97.0%	93.0%	96.2%	91.5%	92.8%	92.9%	93.3%	93.8%
Total Drilling	**93.0%**	**79.4%**	92.8%	86.1%	90.7%	84.5%	86.7%	87.8%	88.4%	87.8%

Drilling Activity by Geographic Area — 1986 Capital Interest Wells

	Saskatchewan		Alberta		Manitoba	
	Gross	Net	Gross	Net	Gross	Net
Oil	106	8.0	23	9.3	2	2.0
Gas	—	—	1	0.3	—	—
Dry	5	2.3	5	2.8	—	—
Total	**111**	**10.3**	**29**	**12.4**	**2**	**2.0**

Historical Land Position

(thousands of net acres)

	1986	1985	1984	1983	1982
By Activity					
Balance at beginning of year	755	1,104	1,831	2,219	N/A
Acquisitions	30	138	70	30	N/A
Net Surrendered/Earned	(10)	(487)	(797)	(418)	N/A
Balance at end of year	**775**	755	1,104	1,831	2,219

1986 Land Position — Producing vs. Non-Producing

(thousands of acres)

	Producing		Non-Producing	
	Gross	Net	Gross	Net
Saskatchewan	354	132	868	473
Alberta	53	18	425	119
Manitoba	1	1	52	32
Total	**408**	**151**	**1,345**	**624**

Production

(thousands of barrels)

	1986	1985	1984	1983	1982
Saskatchewan					
Light/Medium					
South West	1,567.3	1,717.1	1,830.3	1,634.4	1,384.0
South East	1,107.2	1,132.1	1,119.5	1,163.2	961.0
West Central	213.6	88.1	88.1	—	—
Heavy					
West Central	1,162.1	1,251.6	1,325.2	1,121.9	837.3
North West	552.6	603.8	700.1	723.2	713.0
Alberta & Other	153.3	106.9	88.0	61.1	89.3
Total	**4,756.1**	4,899.6	5,151.2	4,703.8	3,984.6
Total Light/Medium	3,029.2	3,031.6	3,125.9	2,858.7	2,434.3
Total Heavy	1,726.9	1,868.0	2,025.3	1,845.1	1,550.3
Average Daily Oil Production	13.0	13.4	14.1	12.9	10.9

Gas Production

(millions of cubic feet)

	1986	1985	1984	1983	1982
Total	**1,420**	710	568	355	142
Average Daily Gas Production	3.9	1.9	1.6	1.0	0.4

1986 Monthly Oil Production

(thousands of barrels)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sept	Oct	Nov	Dec
Light/Medium	217	223	208	290	267	255	252	281	255	271	219	291
Heavy	186	149	130	82	122	149	141	148	151	160	156	153
Total	403	372	338	372	389	404	393	429	406	431	375	444

Average Price of Oil

($CDN per barrel)

	1986	1985	1984	1983	1982
Light/Medium	16.90	33.40	31.20	28.60	24.64
Heavy	13.25	31.32	31.05	29.86	28.04
Combined Average Price	**15.59**	32.60	31.16	29.06	25.94

1986 Monthly Average Price

($CDN per barrel)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sept	Oct	Nov	Dec
Light/Medium	30.58	19.26	16.83	14.25	16.17	15.02	12.33	15.30	16.73	15.67	16.01	16.39
Heavy	25.05	14.98	14.00	7.83	12.38	13.20	8.73	12.65	11.40	11.05	10.96	11.43
Combined Average Price	28.37	18.11	14.46	12.54	15.20	14.17	11.63	14.55	14.91	14.10	14.03	14.82

1986 Financial Review

Highlights

The past year was characterized by substantially lower oil prices. The average price Saskoil received for its production mix reached a low point in the third quarter and only recovered slightly by year-end. However, world oil prices have been stronger during early 1987.

The effect of lower prices on 1986 financial results is significant. Working capital from operations is down 59 percent to $26 million. Capital expenditures were cut back by the same proportion to $24 million, reflecting lower cash flow.

The public share issue of $110 million completed in January 1986, provided $30 million of equity to Saskoil after paying a $75 million dividend to the Province of Saskatchewan from the issue proceeds. This increased cash to over $42 million by year-end.

Despite adverse economic conditions, Saskoil had earnings before income taxes of $1.3 million, compared to $40.6 million in 1985. Cash flow per common share was $1.07 and the loss per common share after deducting income tax and preferred share dividends was $0.34.

Results of Operations

Oil production dropped slightly to 4.75 million barrels, or approximately 13,000 barrels per day. Saskoil's average oil price for the year was $15.59 Cdn. per barrel, a drop of 52 percent from our 1985 average price of $32.60. The average price for January 1987, was about $18 Cdn., reflecting a recovery in world price levels.

Gross oil and gas sales, including $3 million of natural gas sales, were $77.3 million, down from 1985 in proportion to the decline in oil prices.

Royalties of $19 million were paid in 1986, compared to $48 million in 1985 resulting in a 1986 average oil royalty rate of 25.3 percent versus 29.9 percent. The decrease in this rate is because of the six-month Saskatchewan royalty relief program which was in place from May through October. The program was not extended beyond October, resulting in extra royalties of about $1 million for the balance of the year. The Province of Saskatchewan implemented a price sensitive royalty regime in January 1987, which provides lower royalty rates at current prices and further royalty holidays for new oil wells. Saskoil's concentration on Alberta exploration should result in lower royalty rates on new production due to the more favourable Alberta royalty regime.

Saskoil Average Oil Prices
($Cdn per barrel)

Operating expenses of $26 million remained at about the same level as 1985, excluding a non-recurring write-off in 1985. Oil lifting costs per barrel were about $5.30 for both years.

The higher cost of proved reserve additions increased depletion and depreciation by six percent to $23 million. The method of depletion and depreciation of oil and gas assets was changed to comply with a new accounting guideline issued in 1986 by the Canadian Institute of Chartered Accountants as described in notes 1 and 2 to the financial statements. The accounting change did not significantly affect 1986 earnings.

1986 Netbacks
($Cdn per barrel)

	Heavy	Light/ Med.	Total
Production (000's bbls)	1,727	3,029	4,756
Price	$13.24	$16.91	$15.57
Royalty	(2.89)	(4.62)	(3.99)
Lifting costs	(5.56)	(5.20)	(5.28)
Cash netback	$ 4.79	$ 7.09	$ 6.30
Depletion			(4.42)
Netback			$ 1.88

Gross general and administration expense dropped 16 percent to $15.2 million, excluding re-organization costs of $1.4 million. Net general and administration expense was $11.1 million after recoveries and capitalized overhead, compared to $11.0 million in 1985.

Petroleum and gas revenue tax (PGRT) was eliminated in October, 1986. Payment of $1.7 million in PGRT has been deferred indefinitely. Under the regulations allowing for the deferral, it is anticipated that this amount will not become payable for several years.

There were no income taxes payable in 1986, however, income tax expense less an extraordinary tax reduction resulted in a net charge of $2.6 million to earnings. This charge is fully offset by the deduction of share issue costs, the tax effect of which has been credited directly to retained earnings.

No income tax will be payable for several years as a result of the deductibility of excess expenditures of $93 million, as described in note 7 to the financial statements. This extraordinary tax reduction will continue to offset income tax expense until excess expenditures have been fully utilized.

Financial Position

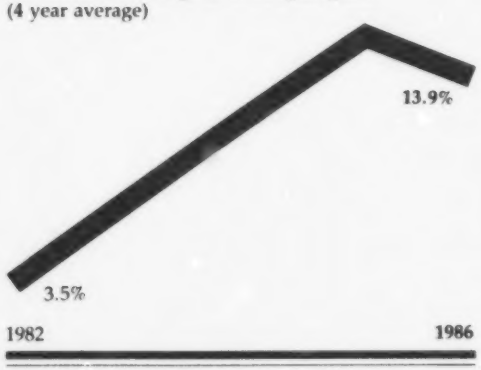
Working capital increased by $25 million, reflecting $30 million in net proceeds from the share issue less preferred share dividends of $5.3 million. Capital expenditures of $24 million were funded entirely by internal cash flow of $26 million. Exploration and development spending, including capitalized overhead, amounted to $11 million and $13 million respectively.

Working capital at year-end was $48 million, including cash of $42 million. Cash in excess of operational needs has been invested in short term money market instruments. The interest thereon is the major component of interest and other revenue amounting to $6 million.

Incentives receivable from the Province of Saskatchewan have been reclassified as non-current, and have resulted in a $3 million reduction of working capital. The province has indefinitely suspended payment of the incentives which had been earned by Saskoil prior to 1985. Under the relevant regulations, the unpaid incentives accrue no interest.

Saskoil has debt of only $15 million in the form of participation bonds due in 1990. Interest on these bonds was $1.9 million in 1986. The bonds can be redeemed at an eight percent premium in 1988.

Return on Capital Employed
(4 year average)



Outlook

Saskoil is in excellent financial position with substantial working capital. A low, long term debt/equity ratio of 1:18 indicates further debt financing capacity in addition to the potential for access to equity markets. These attributes leave Saskoil poised for oil and gas investment through acquisition or merger opportunities and an aggressive 1987 exploration program concentrating on Alberta and select Saskatchewan plays.

AUDITORS' REPORT

To the Shareholders of Saskatchewan Oil and Gas Corporation:

We have examined the consolidated balance sheet of Saskatchewan Oil and Gas Corporation as at December 31, 1986, and the consolidated statements of earnings, retained earnings, and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the Corporation as at December 31, 1986, and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied, except for the change in the full cost method of accounting as explained in note 2, on a basis consistent with that of the preceding year.

Clarkson Gordon
Chartered Accountants

Regina, Canada
February 6, 1987

MANAGEMENT REPORT

The accompanying consolidated financial statements and all information in the Annual Report are the responsibility of management. The consolidated financial statements have been prepared by management in accordance with the accounting policies described herein. Where necessary, management has made informed judgements and estimates in accounting for transactions which were not complete at the Balance Sheet date. In the opinion of management, these statements have been prepared within acceptable limits of materiality and are in accordance with Canadian generally accepted accounting principles appropriate in the circumstances. The financial information elsewhere in this Report has been reviewed to ensure consistency with that in the consolidated financial statements.

Management maintains appropriate systems of internal control including an internal audit function. Policies and procedures are designed to give reasonable assurance that transactions are appropriately authorized, assets are safeguarded and financial records properly maintained to provide reliable information for the preparation of financial statements.

Clarkson Gordon, an independent firm of Chartered Accountants, has been engaged, as approved by a vote of the shareholders at the Company's most recent Annual General Meeting, to examine the consolidated financial statements in accordance with generally accepted auditing standards in Canada and provide an independent professional opinion. Their Auditor's Report is presented below.

The Audit Committee of the Board, which is comprised of directors who are not employees of the Corporation, has reviewed the consolidated financial statements, including the notes thereto, with management and both the internal and the external auditors. The consolidated financial statements have been approved by the Board of Directors on the recommendation of the Audit Committee.

Peter W. Kreutzer
Vice-President, Finance,
and Chief Financial Officer

CONSOLIDATED BALANCE SHEET AS AT DECEMBER 31, 1986

	Note	1986	1985
		(thousands of dollars)	
Assets			
Current Assets			
Cash, including short-term investments		$ 42,473	$ 24,202
Accounts receivable		13,843	26,104
Inventories and prepaid expenses		3,376	3,929
		59,692	54,235
Property and Equipment	3	229,249	229,850
Other	4	3,490	444
		$292,431	$284,529
Liabilities			
Current Liabilities			
Accounts payable and accrued liabilities		$ 11,899	$ 22,062
Petroleum and gas revenue tax		—	9,765
		11,899	31,827
Deferred Petroleum and Gas Revenue Tax	7	1,672	—
Deferred Gas Revenue		286	322
Dividend Payable		—	75,000
Participation Bonds	5	15,000	15,000
		28,857	122,149
Shareholders' Equity			
Share Capital	6	255,500	145,500
Retained Earnings		8,074	16,880
		263,574	162,380
		$292,431	$284,529

Approved by the Board:

Director

Director

CONSOLIDATED STATEMENT OF EARNINGS FOR THE YEAR ENDED DECEMBER 31, 1986

	Note	1986	1985
		(thousands of dollars)	
Revenue			
Crude oil and natural gas sales		$ 77,298	$ 161,120
Less royalties		19,006	47,888
Net sales revenue		58,292	113,232
Interest and other income		6,026	5,975
		64,318	119,207
Expenses			
Operating		25,893	28,405
General and administration		11,053	10,961
Depletion and depreciation		23,043	21,801
Petroleum and gas revenue tax		1,116	13,508
Interest on long term debt		1,940	3,909
		63,045	78,584
Earnings Before Income Tax Expense		1,273	40,623
Income Tax Expense	7	(4,200)	(1,400)
(Loss) Earnings Before Extraordinary Item		**(2,927)**	39,223
Extraordinary Item — Reduction of Income Tax	7	1,600	1,400
(Loss) Earnings		**$ (1,327)**	$ 40,623
Loss Per Common Share Before Extraordinary Item		**$ 0.42**	
Loss Per Common Share	6	**$ 0.34**	

CONSOLIDATED STATEMENT OF RETAINED EARNINGS FOR THE YEAR ENDED DECEMBER 31, 1986

		1986	1985
		(thousands of dollars)	
Retained Earnings, Beginning of Year		$ 16,880	$ 53,034
(Loss) Earnings		(1,327)	40,623
Public Share Issue Costs (1986 – net of tax of $2.6 million)	7	(2,196)	(1,777)
Dividends		(5,283)	(75,000)
Retained Earnings, End of Year		**$ 8,074**	$ 16,880

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION FOR THE YEAR ENDED DECEMBER 31, 1986

	Note	1986	1985
		(thousands of dollars)	
Cash Generated Internally			
Earnings Before Income Tax Expense		$ 1,273	$ 40,623
Add: Depletion and depreciation		23,043	21,801
Other		1,930	1,570
Working capital from operations		**26,246**	63,994
Adjustment to cash basis		(8,194)	4,427
Cash from operations		18,052	68,421
Government incentives received		637	2,361
Proceeds on disposal of assets		113	327
		18,802	71,109
Financing			
Public share issue:	6		
Proceeds		110,000	—
Issue costs		(4,796)	(1,777)
Dividend to Province of Saskatchewan		(75,000)	—
Issue of share capital for equity advances		—	145,500
Reduction of equity advances		—	(145,500)
Repayment of Province of Saskatchewan loan		—	(25,000)
		30,204	(26,777)
Investment in Property and Equipment			
Capital expenditures		23,735	58,813
Adjustment to cash basis		1,717	(95)
		25,452	58,718
Dividends			
Preferred shares		5,283	—
Province of Saskatchewan, declared in 1984		—	6,605
		5,283	6,605
Increase (Decrease) in Cash		**18,271**	(20,991)
Cash, Beginning of Year		24,202	45,193
Cash, End of Year		**$ 42,473**	$ 24,202

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 1986
(tabular figures in thousands of dollars)

1. Summary of Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements of Saskatchewan Oil & Gas Corporation ("Saskoil" or "the Corporation") include the accounts of Saskatchewan Oil and Gas Corporation, a company incorporated under the Saskatchewan Business Corporation Act, and its wholly-owned subsidiaries, Saskoil Resources Inc. and Consumers Oil Limited.

Substantially all exploration and production activities are conducted jointly with others. The consolidated financial statements reflect only Saskoil's proportionate interest in such activities.

Property and Equipment

Capitalized Costs

Saskoil follows the full cost method of accounting in accordance with the accounting guideline issued by the Canadian Institute of Chartered Accountants, whereby all costs related to exploration and development of oil and gas reserves, whether productive or non-productive, are capitalized. Such costs include lease acquisition, geological and geophysical, well drilling, and certain general and administration costs directly related to exploration and development activities.

The net book value of oil and gas assets is limited to an estimated recoverable amount. This amount is the aggregate of future net revenues from proved reserves and certain costs of unproven properties; less future general and administration and financing costs and income taxes. Future net revenues are calculated using prices in effect at the Corporation's year end without escalation or discounting. Any excess of net book value over the estimated recoverable amount is charged to earnings.

Depletion and Depreciation

Depletion and depreciation of oil and gas assets is calculated using the unit-of-production method. For purposes of the calculation, gross proved oil and gas reserves, as determined by corporate or independent engineers, are converted to a common unit of measure on the basis of their approximate relative energy content.

Depreciation of other property and equipment is calculated at rates which charge original costs to operations over the estimated useful lives using the straight-line method.

Dispositions

Proceeds from the disposition of oil and gas assets are generally applied against the net book value of property and equipment; no gain or loss is recorded unless such treatment would significantly alter the relationship between the net book value and proved reserves. Gains and losses on other property and equipment dispositions are recognized in the statement of earnings.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 1986

(tabular figures in thousands of dollars)

2. Change in Accounting Policy

Effective January 1, 1986, Saskoil prospectively adopted the accounting guideline on full-cost accounting in the oil and gas industry issued by the Canadian Institute of Chartered Accountants. The change in the determination of depletion and depreciation and the limitation of net book value of oil and gas assets is as follows:

	Current Method	Previous Method
Reserves used in determining the rate of depletion and depreciation and the limitation of net book value of oil and gas assets	Proved	Proved Producing
Costs subject to depletion and depreciation	Net book value of oil and gas assets at end of year plus future development costs, less certain costs of unproven properties	Net book value of oil and gas assets at beginning of year

If the previous method had been applied in 1986, the effect on the consolidated financial statements would not be material.

3. Property and Equipment

	1986			1985
	Cost	Accumulated Depletion & Depreciation	Net Book Value	Net Book Value
Oil and gas assets:				
Intangible	$254,017	$100,777	$153,240	$154,892
Tangible	107,873	34,608	73,265	71,132
Other	8,204	5,460	2,744	3,826
	$370,094	**$140,845**	**$229,249**	$229,850

General and administration costs of $4.2 million relating to exploration and development activities were capitalized in 1986 ($5.5 million in 1985).

The estimated recoverable amount from proved reserves for purposes of limiting net book value of oil and gas assets was calculated using year end oil prices. These prices were based on a West Texas Intermediate oil price of approximately $18 U.S., adjusted to reflect the relevant characteristics of Saskoil's reserves.

Costs of $10 million relating to unproven properties were excluded from the depletion and depreciation calculation in 1986.

4. Other Assets

	1986	1985
Incentives receivable from Province of Saskatchewan	$3,151	$ —
Unamortized bond issue costs	339	444
	$3,490	$444

Incentives receivable under the Province of Saskatchewan Oil and Gas Regulations 1978 have been reclassified from current to non-current due to indefinite suspension of payments by the Saskatchewan government. The comparative amount included in accounts receivable in 1985 was $4.3 million.

5. Participation Bonds

The bonds mature March 31, 1990 and are guaranteed as to principal and interest by the Province of Saskatchewan. Interest is payable March 31 of each year at 10% plus .03 percentage points for each full $1 million of corporate Net Sales Revenue for the preceding fiscal year.

The interest rate for the year ending March 31, 1987 is 11.74%. (1986 — 13.40%).

The bonds carry a right of redemption at the option of Saskoil at prices of $1,080 and $1,050 per $1,000 of bond principal on March 31, 1988 and 1989, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 1986
(tabular figures in thousands of dollars)

6. Share Capital

	1986		1985	
	Shares Issued	Amount	Shares Issued	Amount
First preferred	none	$ —	none	$ —
Second preferred	7,585,984	75,860	none	—
Common	19,636,238	179,640	15,842,910	145,500
		$255,500		$145,500

Second Preferred Shares

The second preferred shares have voting privileges and are entitled to cumulative dividends of $0.725 per share per annum. These shares are convertible into common shares at the option of the holder at a rate of conversion of 1.0 common share for each preferred share prior to the close of business on December 31, 1988, and at a rate of 0.833 thereafter until the close of business on December 31, 1995.

The shares are redeemable at the option of Saskoil after the close of business on December 31, 1988, and prior to the close of business on December 31, 1990, depending on future prices of the common shares on The Toronto Stock Exchange. Thereafter, the shares are redeemable at prices declining $0.20 per share annually from $11.00 to $10.00.

Legal Restrictions

The Saskatchewan Oil and Gas Corporation Act, 1985, prohibits any person or group of associated persons, other than the Province of Saskatchewan, from owning more than 4% of the issued and outstanding voting shares of Saskoil. In addition, the Act provides that holders of voting shares of Saskoil must be Canadian citizens or residents.

Shares Issued and Conversions

Share issues in December 1985 and January 1986 resulted in the status of Saskoil changing from a crown corporation without share capital to a crown-controlled corporation with significant public ownership.

In December 1985 the Province of Saskatchewan converted equity advances of $145,500,000 to 15,842,910 common shares. In January 1986 the corporation completed a public share issue of 7,586,208 second preferred and 3,793,104 common shares for cash consideration of $75,862,080 and $34,137,936, respectively. A dividend of $75,000,000, declared in 1985, was paid to the Province of Saskatchewan from the proceeds of the share issue.

During the year, 224 second preferred shares with a stated value of $2,240 were converted to common shares.

Earnings Per Common Share

Saskoil was a wholly owned subsidiary of a crown corporation at December 31, 1985; accordingly, comparative earnings per share are not provided.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 1986

(tabular figures in thousands of dollars)

7. Income Tax Expense, Extraordinary Item and Deferred Petroleum and Gas Revenue Tax

The table below explains the differences between expected income tax expense (as obtained by applying statutory income tax rates), the recorded income tax expense, and income tax payable of nil.

	1986	1985
Statutory income tax rate	54.5%	52.9%
Expected income tax expense (1985 — based on earnings for period December 15-31)	$ 694	$1,074
Add (deduct) tax effect of:		
Royalties, rentals and similar payments to provinces	8,876	938
Petroleum and gas revenue tax	609	248
Federal resource allowance	(4,508)	(575)
Earned depletion allowance	(1,149)	(323)
Other	(322)	38
Income tax expense	**$4,200**	$1,400
Public share issue cost tax effect	(2,600)	—
Extraordinary Item	(1,600)	(1,400)
Income tax payable	**$ Nil**	$ Nil

The tax effect of share issue costs has been credited to retained earnings and therefore does not serve to reduce income tax expense.

The extraordinary item is the result of the fact that Saskoil is entitled to reduce taxable income by certain expenditures incurred in prior years, portions of which have been charged to earnings prior to December 15, 1985, the date on which the corporation ceased to be exempt from income tax. The estimated amount of the excess of these expenditures over net book values at December 31, 1986 is $93 million.

The extraordinary item arises as a result of deducting a portion of these excess expenditures in determining taxable income for the year.

Saskoil has deferred its liability for Petroleum and Gas Revenue tax ("PGRT") by utilizing certain of its exploration and development expenditures otherwise available for deduction for income tax purposes. When these expenditures are claimed in the future for income tax purposes, the amount of the deferred PGRT will become payable.

8. Commitments

Minimum lease payments under operating leases for office space and equipment in thousands of dollars are:

1987	$2,487
1988	2,471
1989	2,413
1990	1,928
1991	479
	$9,778

9. Related Party Transactions

The consolidated financial statements include capital, revenue, and expense amounts resulting from routine operating transactions conducted at prevailing market prices with various Saskatchewan crown-controlled departments, agencies, and corporations. Account balances resulting from these transactions are settled on normal trade terms.

Certain information as to related party transactions is not available by virtue of the fact that Saskoil conducts a substantial portion of its exploration and production activities through joint ventures which are not contractually required to report Saskoil's share of routine operating transactions with Saskoil related parties.

10. Comparative Figures

Certain comparative figures have been reclassified to conform with the current year's presentation.

Five Year Summary

Financial
(thousands of dollars)

	1986	1985	1984	1983	1982
Revenue					
Crude oil and natural gas sales	$ 77,298	$161,120	$160,935	$136,047	$103,968
Less royalties	(19,006)	(47,888)	(50,251)	(48,142)	(37,180)
Other income	6,026	5,975	4,309	3,247	1,813
	64,318	119,207	114,993	91,152	68,601
Expenses					
Operating	25,893	28,405	24,509	23,157	17,929
General and administration	11,053	10,961	10,312	10,705	14,183
Depletion and depreciation	23,043	21,801	19,162	12,974	11,639
Petroleum and gas revenue tax	1,116	13,508	14,544	10,222	8,536
Interest on long term debt	1,940	3,909	2,433	3,165	3,458
Income taxes	4,200	1,400	—	—	—
	67,245	79,984	70,960	60,223	55,745
(Loss) Earnings Before the Following	(2,927)	39,223	44,033	30,929	12,856
Unusual items	—	—	—	—	(11,288)
Extraordinary item	1,600	1,400	—	—	—
(Loss) Earnings For the Year	**$ (1,327)**	$ 40,623	$ 44,033	$ 30,929	$ 1,568
Changes in Financial Position:					
Working capital from operations	$ 26,246	$ 63,994	$ 63,578	$ 43,936	$ 24,528
Financing, net of issue costs:					
Equity (1986 - net of $75 million dividend)	30,204	(1,777)	20,000	—	31,000
Debt	—	—	(10,561)	(10,000)	—
Capital expenditures	(23,735)	(58,813)	(44,217)	(30,080)	(31,031)
Dividends	(5,283)	—	(26,605)	(10,000)	(1,568)
Other	(2,047)	4,170	4,198	4,735	4,091
Changes in working capital	$ 25,385	$ 7,574	$ 6,393	$ (1,409)	$ 27,020
Changes in cash	**$ 18,271**	$ (20,991)	$ 28,613	$ 8,673	$ 3,015
Financial Position					
Cash	$ 42,473	$ 24,202	$ 45,193	$ 16,580	$ 7,907
Working capital	47,793	22,408	14,834	8,441	9,850
Property and equipment	229,249	229,850	198,462	177,605	165,234
Long term debt	15,000	15,000	15,000	25,000	35,000
Equity	263,574	162,380	198,534	141,106	140,177

Production and Reserves

(thousands of barrels and millions of cubic feet)

	1986	1985	1984	1983	1982
Production					
Light/Medium oil	3,029	3,032	3,126	2,859	2,434
Heavy oil	1,727	1,868	2,025	1,845	1,551
Total oil	**4,756**	4,900	5,151	4,704	3,985
Total Gas	**1,420**	710	568	355	142
Proved Producing Reserves					
Light/Medium oil	33,145	34,341	34,612	46,040	39,845
Heavy oil	8,835	8,837	11,214	11,617	8,397
Total oil	41,980	43,178	45,826	57,657	48,242
Total Gas	13,420	2,024	2,308	26,412	40,790
Changes in proved producing oil reserves:					
Reserves, beginning of year	43,177	45,826	57,657	48,242	35,901
Additions by development	1,031	3,912	2,195	4,252	2,082
Revisions of previous estimates	2,528	(1,661)	(8,875)	9,867	14,244
Production	(4,756)	(4,900)	(5,151)	(4,704)	(3,985)
Reserves, end of year	**41,980**	43,177	45,826	57,657	48,242
Proved Non-Producing Reserves					
Oil	1,691	3,484	4,346	—	—
Gas	30,637	28,400	15,372	—	—
Probable Reserves					
Oil	24,994	23,976	20,385	—	—
Gas	24,673	12,496	16,934	—	—

Financial Ratios and Statistics

Royalties as % of sales	24.6%	29.7%	31.2%	35.4%	35.8%
Working capital ratio	5.0:1	1.7:1	1.2:1	1.3:1	1.4:1
Return on average capital employed	0.2%	18.3%	21.8%	18.9%	3.1%
Four year return on average capital employed	13.9%	16.3%	12.2%	7.8%	3.5%
Cash flow per share	$1.07	—	—	—	—
(Loss) Earnings per common share	$(0.34)	—	—	—	—
Long term debt/equity ratio	1:17.6	1:10.8	1:13.2	1:5.6	1:4.0
Drilling (gross wells)	169	652	429	253	160
Average oil price ($/barrel)	$15.59	$32.60	$31.16	$29.06	$25.94
Number of employees, end of year	220	292	259	274	315

Shareholders' Information

Saskoil has two types of shares, both of which entitle holders to vote at the shareholders' annual meeting:

Common Shares

At the end of 1986, there were 19,636,238 common shares outstanding which were registered in the names of 8,328 Canadian citizens or residents. The Government of Saskatchewan owns 15,842,910 common shares representing 81 percent of those outstanding. Although the government has the power to exercise voting privileges commensurate with its ownership, it has indicated that it intends to participate in ownership, not management, of Saskoil and that it does not intend to vote its shareholding on resolutions moved at general meetings.

During 1986, 1,346,810 common shares were traded on the stock exchanges representing 35 percent of those available for trading. Share prices fluctuated from a high of $8.00 in January to a low of $4.50 in February.

Listed

Toronto Stock Exchange
Toronto, Canada

Montreal Exchange
Montreal, Canada

Symbol: "SKO"

Transfer Agent and Registrar

The Royal Trust Company
Regina, Montreal, Toronto, Winnipeg, Calgary, and Vancouver

Convertible Preferred Shares

Saskoil had 7,585,984 preferred shares outstanding at the end of 1986, which were registered in the names of 8,706 Canadian citizens or residents. Each convertible preferred share is convertible into common shares of Saskoil at the option of the holder prior to the close of business on December 31, 1988 at a conversion price of $10.00 per common share and, prior to the close of business on December 31, 1995, at a conversion price of $12.00 per common share. Assuming full conversion of the convertible preferred shares, the Province of Saskatchewan will own 58 percent of the common shares of Saskoil.

During 1986, Saskoil paid preferred shareholders a total of $5.3 million at a rate of $0.725 per share per annum through quarterly installments of $0.18125 on June 30, September 30, and December 31. The initial dividend payment on March 31 was $0.153 per share due to the issue date of January 14, 1986.

A total of 2,077,557 preferred shares were traded during the year representing 27 percent of those outstanding. The price of a preferred share reached a high of $10.38 in January and a low of $8.13 in March.

Listed

Toronto Stock Exchange
Toronto, Canada

Montreal Exchange
Montreal, Canada

Symbol: "SKO PR A"

Transfer Agent and Registrar

The Royal Trust Company
Regina, Montreal, Toronto, Winnipeg, Calgary, and Vancouver

Auditors

Clarkson Gordon
Chartered Accountants
Regina, Saskatchewan
Canada

Investor Relations

We regularly provide our shareholders with information about our operations. The annual report is available in March, while quarterly reports are issued five to six weeks after the end of each quarter. Approximately six weeks before our shareholders' annual meeting — usually held in the first week in May — we mail to our shareholders a notice of meeting, information circular, and proxy card. Saskoil also carries out a regular communications program with stock market analysts and investment dealers in order to assist them in keeping our shareholders informed. In some cases, investment dealers or banks will hold shares in their name on behalf of their customers. When this happens, published materials often are not received by shareholders. Copies of Saskoil publications and information on the Direct Dividend Deposit service can be obtained by writing to the Manager, Investor Relations, P.O. Box 1550, 1945 Hamilton Street, Regina, Saskatchewan, S4P 3C4.

Annual Meeting

The annual general meeting of the shareholders will be held at the Ramada Renaissance Hotel, Saskatoon, Saskatchewan on May 5, 1987 at 1:30 p.m., C.S.T.

Hotline

Shareholder inquiries can be directed to Saskoil by dialing toll free 1-800-667-5810. Our Investor Relations staff will be pleased to provide you with a prompt response to your inquiry.

General Inquiries

Effective June 1, 1987, general telephone inquiries can be directed to Saskoil by dialing (306) 781-8200. Up to and including May 30, 1987, the number will be (306) 787-9700.

1986 Trading Range of Common Shares

Toronto Stock Exchange

	Volume	High	Low	Variance
First Quarter	365,954	$8.00	$4.50	$3.50
Second Quarter	441,894	$6.75	$4.75	$2.00
Third Quarter	275,386	$6.38	$4.90	$1.48
Fourth Quarter	263,576	$5.88	$5.25	$0.63

1986 Trading Range of Preferred Shares

Toronto Stock Exchange

	Volume	High	Low	Variance
First Quarter	819,911	$10.38	$8.13	$2.25
Second Quarter	540,314	$9.63	$8.25	$1.38
Third Quarter	473,735	$9.13	$8.38	$0.75
Fourth Quarter	243,597	$9.50	$8.50	$1.00

Geographic Distribution of Common Shares

(as at December 31, 1986)

Area Description	# Of Holders	# Shares Held	% Shares To Total	% Holders To Total
Saskatchewan	7,522	16,791,599*	85.51	90.32
Alberta	229	67,727	0.35	2.80
Ontario	211	2,395,587	12.20	2.53
British Columbia	192	272,408	1.39	2.30
Manitoba	85	18,189	0.09	1.02
Quebec	49	58,352	0.30	0.58
Nova Scotia	18	25,953	0.13	0.21
New Brunswick	13	2,520	0.01	0.15
Other	9	3,903	0.02	0.09
TOTAL	**8,328**	**19,636,238**	**100.00**	**100.00**

*15,842,910 held by the Government of Saskatchewan

Geographic Distribution of Preferred Shares

(as at December 31, 1986)

Area Description	# Of Holders	# Shares Held	% Shares To Total	% Holders To Total
Saskatchewan	7,580	1,869,197	24.64	87.06
British Columbia	368	395,665	5.21	4.23
Alberta	300	263,489	3.47	3.45
Ontario	258	4,706,038	62.04	2.96
Manitoba	92	42,428	0.56	1.06
Quebec	72	236,215	3.11	0.83
Nova Scotia	17	66,506	0.88	0.20
New Brunswick	14	5,640	0.07	0.16
Other	5	806	0.02	0.05
TOTAL	**8,706**	**7,585,984**	**100.00**	**100.00**

Corporate Information

Trademark

Saskatchewan Oil and Gas Corporation holds the saskoil trademark.

Directors

Chairman
Herbert C. Pinder, Jr. (1)(3)
President,
Herbus Holdings Ltd.
Saskatoon, Saskatchewan
• Various entrepreneurial activities

Vice-Chairman
Theodore M. Hanlon (1)
President,
Sage Holdings Ltd.
Calgary, Alberta
• Oil and Potash service and supply

William J. Douglas (1)(3)
President and Chief Executive Officer,
Saskatchewan Oil and Gas Corporation
Regina, Saskatchewan

Robert G. Bentall
President and Chief Executive Officer,
Bentall Group
West Vancouver, British Columbia
• Real estate development

W. John Brennan (2)
Dean of Commerce,
University of Saskatchewan
Saskatoon, Saskatchewan

Donald K. MacPherson, Q.C.
Senior Partner,
MacPherson, Leslie and Tyerman
Regina, Saskatchewan
• Barristers and Solicitors

Thomas A. McLellan
Executive Vice-President and Secretary,
Agra Industries Ltd.
Saskatoon, Saskatchewan
• Various industrial operations

Theodore H. Renner (3)
President and Chief Executive Officer,
Mark Resources Inc.
Calgary, Alberta
• Oil and gas exploration
and development

Rose M. Richardson (2)
President,
Fuhrmann Meats Ltd.
Regina, Saskatchewan
• Meat processing

Garnet K. Wells (2)
Chief Financial Officer,
PCL Construction Group Ltd.
Edmonton, Alberta
• Commercial construction

(1) Member of the
Executive Committee
(2) Member of the Audit Committee
(3) Member of the
Compensation Committee

Directors Bentall, Brennan, MacPherson, Renner, Richardson and Wells were appointed to the Board of Directors by the Lieutenant-Governor in Council, Government of Saskatchewan. Directors Pinder Jr., Douglas, Hanlon and McLellan were elected by the shareholders at the annual general meeting of the shareholders in Regina, May 5, 1986.

Directors Pinder Jr. and Hanlon were appointed Chairman and Vice-Chairman respectively by the Board of Directors of the Corporation.

Officers

William J. Douglas
President and Chief Executive Officer

Peter W. Kreutzer
Vice-President,
Finance and Chief Financial Officer

Dale M. Christensen
Vice-President,
Production

J. Gerald Gribben
Vice-President,
Administration

Donald L. Tough
Vice-President,
Exploration and Development

Carl A. P. Wagner
Secretary

Head Office

Saskatchewan Oil and Gas Corp.
1000 Saskoil Tower
1945 Hamilton Street
P.O. Box 1550
Regina, Saskatchewan
S4P 3C4

Calgary Office

Saskoil Resources Inc.
2400 Bow Valley Square 2
205 - 5th Ave. S.W.
Calgary, Alberta
T2P 2V7

District Offices

South East District
P.O. Box 519
Estevan, Saskatchewan
S4A 2A5

South West District
P.O. Box 1718
Swift Current, Saskatchewan
S9H 4G6

West Central District
P.O. Box 248
Coleville, Saskatchewan
S0L 0K0

North West District
P.O. Box 610
Maidstone, Saskatchewan
S0M 1M0

Annual Report

Production
Investor Relations, Saskoil

Concept and Design
Pinvidic Communications,
Regina, Saskatchewan

Photography
Douglas Walker Photography,
Regina, Saskatchewan

Lithography
Centax of Canada
Regina, Saskatchewan

Printed in Canada

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Bill Douglas